RAND Research Brief

Modifying Federal Civil Service Retirement Incentives

In recent decades, concerns have been expressed about two related labor force problems in the federal civil service: (1) insufficient turnover among mid- and late-career personnel and (2) the loss of key senior personnel to retirement as soon as they become eligible (generally, age 55). Lack of turnover can clog the promotion pipeline, preventing the hiring or advancement of better-trained or more-skilled individuals. The premature loss of senior personnel can impose significant direct and indirect costs: it is often difficult and time-consuming to find qualified replacements.

Some observers have attributed these problems in large part to the Civil Service Retirement System (CSRS), which was thought to create "golden handcuffs" by significantly reducing the value of retirement benefits of those leaving prior to their first age of eligibility. These observers hypothesized that the new, redesigned system called the Federal Employees Retirement System (FERS), introduced in 1987, would correct these problematic separation and retirement patterns.

In a recent RAND report, *Separation and Retirement Incentives in the Federal Civil Service: A Comparison of the Federal Employees Retirement System and the Civil Service Retirement System*, Beth Asch and John Warner analyze FERS to determine whether its retirement and separation incentives are consistent with these hypotheses. In other words, does FERS increase turnover among mid- and late-career individuals and defer retirement among those in senior positions? As part of this analysis, Asch and Warner also examine the relative generosity of FERS versus CSRS, assessing whether employees "grandfathered in" under the CSRS system were likely to switch to FERS during the "open" switching period available in the second half of 1998.

FERS IS A MORE GENEROUS SYSTEM THAN CSRS

Asch and Warner found that under a variety of assumptions, FERS appears to produce greater expected net lifetime earnings and retirement wealth than CSRS. The relative advantage of FERS increases for those entering the civil service later in life because FERS grants full Social Security coverage, whereas CSRS partially deducts Social Security benefits from its retirement annuities. This deduction has a greater effect on older civil service entrants because they have often accumulated at least some Social Security benefits from prior employment.

Although FERS (unlike CSRS) does include an option to invest retirement funds in the stock market, FERS relative generosity is not due to the enormous growth in stock market returns in recent years. Instead, a combination of factors causes FERS to produce greater net wealth, including full Social Security coverage, a rate of return on funds invested in the stock market that provides protection from inflation, and the cumulative effect of receiving benefits from three sources (FERS defined benefit annuity, Social Security, and stock market returns).

RETIREMENT INCENTIVES UNDER FERS ARE NOT ENTIRELY CONSISTENT WITH PREVAILING HYPOTHESES

Surprisingly, FERS and CSRS embed identical retirement age incentives, assuming a minimum retirement age of 55 for FERS. Because both systems maximize net lifetime wealth at the same age and number of years of service, from an economic standpoint, individuals covered by either system will have an incentive to retire at the same age. However, the minimum retirement age under FERS rises with birth year, peaking at age 57 for those born after

1970. Since recent hires are more likely to have been born after 1970, FERS will successfully delay retirement incentives for this subset of individuals until age 57, assuming they meet the requisite number of years of service.

Under both FERS and CSRS, those who choose to retire before or after their wealth-maximizing age suffer financial penalties. FERS imposes a smaller penalty than CSRS because it offers greater potential for inflation protection for those who leave prior to their wealth-maximizing age, and a larger annuity for those who leave after that time. Because the financial penalty under FERS is smaller, senior personnel covered by FERS are more likely to stay in the civil service beyond their minimum retirement age. However, they are also more likely to leave earlier, which is not consistent with the prevailing hypotheses about FERS.

SEPARATION INCENTIVES UNDER FERS VARY BY CAREER STAGE

Asch and Warner's analysis indicates that those covered by FERS have a stronger incentive to stay in the civil service if they are at the beginning or middle of their careers, but a weaker incentive to stay if they are nearing retirement. (Since FERS is a more generous system than CSRS, these individuals have more to lose by early separation.) Asch and Warner's analysis of actual separation rates appears to support this conclusion: early and mid-career individuals covered by CSRS separate at a rate of approximately 4.4 percent, while those covered by FERS appear to separate at a rate of 2.4 percent. Even if this analysis overestimates the difference between the two rates, the results still indicate that FERS has not increased separation rates among mid-career personnel, as some observers had thought. Instead, it is likely to be producing substantially lower separation rates. (The study was unable to compare empirical separation rates for senior personnel because too little time has elapsed for anyone to have completed an entire career under FERS.)

THE DECISION TO SWITCH FROM CSRS TO FERS DEPENDS ON FUTURE EXPECTATIONS

Individuals who face the decision to switch from CSRS to FERS early in their careers can increase their net lifetime earnings and retirement wealth at retirement by converting to FERS, given the assumptions of the authors' analysis. Outcomes for individuals facing the decision later in their careers, though, are not as clear. Those outcomes depend on *both* an individual's separation and retirement plan as well as his or her career expectations. Those who plan to leave the civil service at retirement are better off under CSRS, while those who plan to separate prior to retirement are better off under FERS, given the authors' assumption of a relatively modest 6 percent rate of return on stock market investments. However, if one assumes a higher 15 percent real rate of return, then those in their mid- to late-career periods are uniformly better off by switching to FERS. Thus, the extent to which individuals switched during the "open" period referred to above would depend largely on *what they believe about future stock market returns*. Since FERS costs employers more than CSRS, differences in the number of personnel switching could have significant cost implications for civil service agencies.

POLICY IMPLICATIONS

Although FERS and CSRS embed the same retirement incentives, FERS will ultimately be more successful at inducing employees to retire later because it is gradually phasing in a higher minimum retirement age. However, FERS appears to be less successful at increasing separation rates among those in their early and mid-careers. The lower separation rates observed under FERS suggest that additional approaches will be necessary to reach the desired turnover targets. In future research, it would be useful to indicate whether other forms of compensation, such as separation pay, would be effective in meeting those targets.

RAND research briefs summarize research that has been more fully documented elsewhere. This research brief describes work done for the National Defense Research Institute; it is documented in Separation and Retirement Incentives in the Federal Civil Service: A Comparison of the Federal Employees Retirement System and the Civil Service Retirement System, *by Beth J. Asch and John T. Warner, MR-986-OSD, 1999, 64 pp., $15.00, ISBN: 0-8330-2689-5, available from RAND Distribution Services (Telephone: toll free 877-584-8642; FAX: 310-451-6915; or Internet: order@rand.org). Abstracts of all RAND® documents may be viewed on the World Wide Web (http://www.rand.org). Publications are distributed to the trade by NBN. RAND® is a registered trademark. RAND is a nonprofit institution that helps improve policy and decisionmaking through research and analysis; its publications do not necessarily reflect the opinions or policies of its research sponsors.*

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